



STATE BOARD OF EQUALIZATION

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Fourth District, Los Angeles

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State Controller

August 12, 2011

KRISTINE CAZADD
Interim Executive Director

Dear Interested Party:

Enclosed is the Initial Discussion Paper on Regulation 1685.5, *Calculation of Estimated Use Tax – Use Tax Table*. Discussion regarding proposed amendments to Regulation 1685.5 is scheduled for the Board's **December 15, 2011 Business Taxes Committee** meeting.


However, before the issue is presented at the Business Taxes Committee meeting, staff would like to provide interested parties an opportunity to discuss the issue and present any suggested changes or comments. Accordingly, a meeting is scheduled in **Room 122 at 10:00 a.m. on August 29, 2011**, at the Board of Equalization; 450 N Street; Sacramento, California.

If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please write to me at the above address or send a fax to (916) 322-4530 before the August 29, 2011 meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on August 29, 2011, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Mr. Robert Wilke at (916) 445-2137 or by e-mail at Robert.Wilke@boe.ca.gov prior to August 25, 2011. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing. In addition, please let Mr. Wilke know if you wish to have future correspondence, including the second discussion paper and all attachments, sent to your e-mail address rather than to your mailing address.

Whether or not you are able to attend the above interested parties' meeting, please keep in mind that the due date for interested parties to provide written responses to staff's analysis is **September 13, 2011**. Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

Thank you for your consideration. I look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Leila Hellmuth, Supervisor, Business Taxes Committee Team, at (916) 322-5271.

Sincerely,



Susanne Buehler
Chief, Tax Policy Division
Sales and Use Tax Department

SB: rsw

Enclosures

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC 71)
Senator George Runner (Ret.), Member, Second District (MIC 78)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(Via E-mail)

Mr. Robert Thomas, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Lee Williams, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Kristine Cazadd
Mr. Randy Ferris
Mr. Jeffrey L. McGuire
Mr. Jeff Vest
Mr. David Levine
Mr. Bradley Heller
Mr. Robert Tucker
Mr. Todd Gilman
Ms. Laureen Simpson
Mr. Robert Ingenito Jr.
Mr. Bill Benson
Mr. Stephen Rudd
Mr. Kevin Hanks
Mr. Jason Parker
Mr. Geoffrey E. Lyle
Ms. Leila Hellmuth
Mr. Robert Wilke
Mr. Bradley Miller

INITIAL DISCUSSION PAPER

Regulation 1685.5, *Calculation of Estimated Use Tax – Use Tax Table*

Issue

Whether it is necessary to amend Regulation 1685.5, *Calculation of Estimated Use Tax – Use Tax Table*, to update the manner in which the Board shall annually calculate the estimated amount of use tax due according to a person's adjusted gross income and make such amounts available to the Franchise Tax Board (FTB) in the form of a use tax table for calendar-year 2012 and subsequent years.

Background

Section 6452.1 of the Revenue and Taxation Code (RTC), as amended by Senate Bill No. 86 (Stats. 2011, Ch. 14) approved by the Governor on March 24, 2011, requires the Board to annually calculate the estimated amount of use tax due according to a person's adjusted gross income and, by July 30 of each calendar year, make available to the Franchise Tax Board (FTB) such amounts in the form of a use tax table for inclusion in the instructions to the FTB's income tax returns. Section 6452.1 also gives eligible consumers the option to satisfy their use tax obligations with regard to their nonbusiness purchases of individual items of tangible personal property each with a sales price of less than one thousand dollars (\$1,000) by reporting their estimated amount of use tax as calculated by the Board on their California income tax returns. Furthermore, section 6452.1 includes a "safe harbor" provision that precludes the Board from assessing the difference between a consumer's reported estimated use tax liability based on the Board's use tax table and the consumer's actual use tax liability, for eligible nonbusiness purchases, provided the consumer uses the table correctly.

The Board adopted Regulation 1685.5 (Exhibit 1) on July 26, 2011. The Board anticipates that Regulation 1685.5 will be approved by the Office of Administrative Law (OAL) by September 1, 2011, and that the regulation will become effective approximately 30 days after approval. The Board was unable to hold interested parties meetings to discuss Regulation 1685.5 prior to beginning the formal rulemaking process given the statutory requirement that the Board provide the 2011 use tax table to the FTB by July 30, 2011, and other practical deadlines. However, the Board directed staff to meet with interested parties to discuss whether Regulation 1685.5 needs to be amended before the Board is required to estimate consumers' use tax liabilities and prepare a use tax table for 2012.

Discussion of the Use Tax Table

The use tax law has been in existence since 1935. California's use tax generally applies to the storage, use, or other consumption of tangible personal property in California that was purchased from an out-of-state retailer. (RTC § 6201.) California's use tax is intended to eliminate the incentive for California consumers to purchase tangible personal property from out-of-state retailers in order to avoid paying the sales tax that would apply if the property was sold in California.

California's use tax is imposed on consumers. (RTC § 6202.) However, out-of-state retailers that are engaged in business in California must register with the Board and collect any applicable

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use tax from their California customers. (Regulation 1684.) Furthermore, consumers may satisfy their use tax liabilities by paying applicable use taxes to retailers that are registered with the Board and retaining receipts showing that they paid the taxes. Otherwise, consumers are required to report and pay their own use tax liabilities. (Regulation 1685.)

California consumers that do not maintain complete records of their purchases of tangible personal property throughout the year may have difficulty determining how much they spent on purchases of tangible personal property from out-of-state retailers, and whether they paid use tax to the out-of-state retailers when they made their purchases. In addition, some consumers may have difficulty determining the cumulative rate of state, local, and district use tax applicable to their purchases of tangible personal property. The optional use tax table prescribed by Regulation 1685.5 is intended to make it more convenient for eligible consumers to comply with their use tax reporting obligations by eliminating the need for each consumer to maintain records regarding eligible nonbusiness purchases, and the need for each consumer to determine his or her own cumulative state, local, and district use tax rate. Eligible consumers include those persons who are not required to hold a seller's permit or register with the Board of Equalization under the Sales and Use Tax Law.

With respect to the allocation of total use tax paid, the amounts received from the use tax line on the FTB returns will continue to be allocated according to the taxpayer's address as received by the FTB. Local taxes will be allocated to the countywide pools and applicable district taxes will be allocated based on the countywide pools, with consideration given as to whether the taxpayer's address is within a city that imposes a district tax. The balance is then allocated to the statewide components of the use tax rate.

Methodology

Regulation 1685.5 prescribes a reasonable methodology for estimating consumers' use tax liabilities based upon their adjusted gross income ranges using a "use tax liability factor" determined by:

1. Multiplying the percentage of total personal income spent on electronic and mail order purchases for the preceding calendar year, as determined from data provided by the United States Bureau of Economic Analysis and the United States Census Bureau, by 0.37, which represents the estimated percentage of California consumers' total purchases of tangible personal property for use in California that are made from out-of-state retailers that are not registered with the Board to collect use tax from their customers; and
2. Multiplying the product by the weighted average state, local, and district sales and use tax rate, and then rounding the result to the nearest thousandth of a percent.

(An example of the calculation is provided below.) The Board has determined that this methodology provides a reasonably accurate estimate of California consumers' use tax liabilities based upon the assumptions that California consumers spend an average percentage of their incomes on electronic and mail order purchases and that they also make an average percentage of their total purchases of tangible personal property for use in California from unregistered out-of-

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state retailers. The Board recognizes that a particular consumer's actual use tax liability may be higher or lower than the consumer's estimated use tax liability as determined using the methodology in the regulation, however, that would be the case with any reasonable estimate. In addition, consumers always have the option to report their actual use tax liabilities when they are lower than their estimated use tax liabilities.

The format of the use tax table prescribed by Regulation 1685.5 allows the majority of consumers to find their AGI within an established AGI range and read across to the right column to find their estimated use tax liabilities. However, consumers with AGIs over \$199,999 are required to multiply their actual AGIs by the use tax liability factor specified for their AGI range to determine their estimated use tax liabilities. Therefore, the use tax table eliminates the need for consumers with AGIs that are less than \$199,999 to perform any mathematical calculations to estimate, report, and pay their eligible use tax liabilities, and greatly simplifies the calculations that consumers with AGIs over \$199,999 are required to make to calculate, report, and pay their actual use tax liabilities. Furthermore, the format of the use tax table prescribed by Regulation 1685.5 completely eliminates the need for all eligible consumers to refer to any external sources for additional information, such as the use tax rate, in order to estimate, report, and pay their eligible use tax liabilities.

The AGI ranges used in the use tax table prescribed by Regulation 1685.5 are based on AGI ranges provided by the Franchise Tax Board with a similar percentage of California's taxpayers in each AGI range. Staff understands that nine other states have use tax tables. Of those nine states, three states have more AGI ranges (Maine-11, Oklahoma-31, and North Carolina-31) than California, three states have less AGI ranges (Kansas-6, Massachusetts-6, and Vermont-7) than California, and three have the same number of AGI ranges (Michigan, New York and New Jersey) as California (8).

Example Calculation of Use Tax Liability Factor

The following example illustrates how the use tax liability factor prescribed by Regulation 1685.5 is calculated:

Example of Calculation to Determine Use Tax Liability Factor

I. Determine the percentage of total personal income that is spent on electronic and mail order purchases:

| | |
|--|----------|
| a) U.S. Personal Income (Billions of Dollars) ^{1/} | \$xx,xxx |
| b) U.S. Spending at Electronic Shopping and Mail Order Houses (Billions of Dollars) ^{2/} | \$ xxx |
| c) Percent of Income Spent on Electronic and Mail Order Purchases (b/a) | x.x% |

II. Multiply the result from Step I(c) by .37 ^{3/}:
(c*.37)

.xxxxx

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III. Multiply the product from Step II by the weighted average state, local, district sales and use tax rate (rounded to the nearest thousandth of a percent):

Use Tax Liability Factor (Step II*weighted average tax rate) .xxxx

1/ U.S. Bureau of Economic Analysis

2/ U.S. Census Bureau

3/ Estimated percentage of California consumers total purchases of tangible personal property for use in California that are made from out-of-state retailers that are not registered with the Board to collect use tax from their customers.

Comments Received from Interested Parties

Some interested parties have already commented that they believe:

- The methodology for estimating consumers' use tax liabilities prescribed by Regulation 1685.5 generally over estimates consumers' use tax liabilities;
- The methodology for estimating consumers' use tax liabilities prescribed by Regulation 1685.5 should be revised so that it estimates that consumers in the lower AGI ranges pay more use tax as a percentage of their AGI than consumers in the higher AGI ranges;
- The methodology for estimating consumers' use tax liabilities prescribed by Regulation 1685.5 should be revised due to the enactment of recent amendments to RTC section 6203, which changed the definition of "retailer engaged in business in this state" and may require more out-of-state retailers to register with the Board to collect use tax;
- The format of the use tax table prescribed by Regulation 1685.5 should have more than eight AGI ranges; and
- The format of the use tax table should somehow account for the various district tax rates in effect throughout the state.

As explained above, the Board recognizes that a particular consumer's actual use tax liability may be higher or lower than the consumer's estimated use tax liability as determined using the methodology in the regulation, however, that would be the case with any reasonable estimate. In addition, consumers always have the option to report their actual use tax liabilities when they are lower than their estimated use tax liabilities.

As explained above, the Board does not believe that the methodology for estimating consumers' use tax liabilities prescribed by Regulation 1685.5 fundamentally overestimates consumers' use tax liabilities based upon their adjusted gross incomes. The methodology provides a reasonably accurate estimate of California consumers' use tax liabilities based upon the assumptions that California consumers spend an average percentage of their incomes on electronic and mail order purchases and that they also make an average percentage of their total purchases of tangible personal property for use in California from unregistered out-of-state retailers. However, the Board understands that there is more than one method that can be used to estimate consumers' use tax liabilities based upon their AGIs and has directed staff to discuss ways that the methodology prescribed by Regulation 1685.5 could be improved.

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Board staff understands that, of the nine other states with use tax tables, two states (New York and New Jersey) have use tax tables that estimate that consumers in the lower AGI ranges pay more use tax as a percentage of their AGI than consumers in the higher AGI ranges. Therefore, Board staff is prepared to discuss whether the methodology for estimating consumers' use tax liabilities prescribed by Regulation 1685.5 should be revised so that it estimates that consumers in the lower AGI ranges pay more use tax as a percentage of their AGI than consumers in the higher AGI ranges. Furthermore, the Board publishes issues of Publication 329, *Economic Perspective*, in February, May, August, and November of each year. Board staff has determined that the May 2011 issue of *Economic Perspective* indicates that households with an AGI of \$100,000 or less have proportionately similar spending to income ratios and that households with higher AGIs have lower spending to income ratios. Therefore, staff is also prepared to discuss whether the spending to income ratios documented in the May 2011 issue of *Economic Perspective* should somehow be incorporated into Regulation 1685.5.

The Board did not see a noticeable increase in the number of out-of-state retailers registered with the Board to collect California use tax after the enactment of the amendments to RTC section 6203's definition of retailer engaged in business in this state. Furthermore, on July 18, 2011, the Attorney General delivered the circulating title and summary to the Secretary of State for a proposed statewide referendum regarding the amendments and the Board has directed its Legal Department to request an opinion from the Attorney General regarding the effect of the referendum. Therefore, Board staff would not recommend amending Regulation 1685.5 due to the enactment of the amendments to RTC section 6203 at this time. However, Board staff continues to monitor the effect of the amendments to RTC section 6203, and Board staff would reconsider recommending that the Board amend Regulation 1685.5 to account for the amendments to RTC section 6203 if there is a relevant increase in the number of out-of-state retailers registered with the Board to collect California use tax.

As explained above, staff understands that three of the nine states with use tax tables have use tax tables that employ more AGI ranges than California. Staff also understands that the number of AGI ranges can affect a particular consumer's estimated use tax liability. Therefore, staff is prepared to discuss whether more AGI ranges should be added to Regulation 1685.5 and, if so, how many.

In regard to accounting for each district tax rate in effect throughout the state, there are currently 14 total tax rates, ranging from 7.25% to 9.75%. Although it is possible to create one or more tables that provide an estimated amount of tax by AGI range for each tax rate, this alternative presumes all taxpayers know the rate applicable to their purchases. It should be noted, however, that district tax rates frequently go into effect and expire throughout a given year. Taxpayers who are not certain about the tax rate applicable in their jurisdiction will need to refer to a Board-published list of total tax rates by jurisdiction. Therefore, staff believes that a table that accounts for each cumulative state, local, and district use tax rate in effect in California adds complexity and would likely dissuade consumers from using the use tax tables. Nonetheless, staff is prepared to discuss ways to incorporate varying rates into the use tax tables prescribed by Regulation 1685.5.

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Conclusion

Board staff understands that the optional use tax tables prescribed by Regulation 1685.5 are intended to increase compliance by making it more convenient for consumers to report and pay their use tax liabilities; the tables are not intended or designed to collect a specific amount of use tax nor the entire use tax gap on business to consumer sales. Staff welcomes any comments, suggestions, and input from interested parties. In particular, input that will help improve the methodology for estimating consumers' use tax liabilities prescribed by Regulation 1685.5, but not make it less convenient for consumers to use the Board's use tax tables. Board staff looks forward to discussions regarding this issue.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of: August 12, 2011

Regulation 1685.5. Calculation of Estimated Use Tax – Use Tax Table

Reference: Section 6452.1, Revenue and Taxation Code.

(a) IN GENERAL.

The Board of Equalization (BOE) is required to annually calculate the estimated amount of use tax due according to a person's adjusted gross income (AGI) and make such amounts available to the Franchise Tax Board (FTB), by July 30 of each year, in the form of a use tax table for inclusion in the instructions to the FTB's returns.

(b) DEFINITIONS AND DATA SOURCES.

(1) AGI RANGES. The use tax table shall be separated into eight (8) AGI ranges as follows:

- (A) AGI less than \$20,000;
- (B) AGI of \$20,000 to \$39,999;
- (C) AGI of \$40,000 to \$59,999;
- (D) AGI of \$60,000 to \$79,999;
- (E) AGI of \$80,000 to \$99,999;
- (F) AGI of \$100,000 to \$149,999;
- (G) AGI of \$150,000 to \$199,999;
- (H) AGI more than \$199,999.

(2) USE TAX LIABILITY FACTOR OR USE TAX TABLE PERCENTAGE. For the 2011 calendar year the use tax liability factor or use tax table percentage shall be 0.070 percent (.0007). On May 1, 2012, and each May 1 thereafter, the BOE shall calculate the use tax liability factor or use tax table percentage for the current calendar year by multiplying the percentage of income spent on electronic and mail order purchases for the proceeding calendar year by 0.37, multiplying the product by the average state, local, and district sales and use tax rate, and then rounding the result to the nearest thousandth of a percent.

(3) TOTAL PERSONAL INCOME. Total personal income shall be determined by reference to the most current personal income data published by the United States Bureau of Economic Analysis.

(4) TOTAL SPENDING AT ELECTRONIC SHOPPING AND MAIL ORDER HOUSES. Total spending at electronic shopping and mail order houses shall be determined by reference

to the most current electronic shopping and mail order house spending data published by the United States Census Bureau.

(5) **PERCENTAGE OF INCOME SPENT ON ELECTRONIC AND MAIL ORDER PURCHASES.** The percentage of income spent on electronic and mail order purchases during a calendar year shall be calculated by dividing the total spending at electronic shopping and mail order houses for that year by the total personal income for that year, multiplying the result by 100, and rounding the result to the nearest tenth of a percent.

(6) **AVERAGE STATE, LOCAL, AND DISTRICT SALES AND USE TAX RATE.** The average state, local, and district sales and use tax rate for a calendar year shall be the total of:

(A) The rates of the statewide sales and use taxes imposed under section 35 of article XIII of the California Constitution and the Sales and Use Tax Law (Rev. & Tax. Code, § 6001 et seq.) in effect on January 1 of that year;

(B) The statewide rate of local tax imposed under the Bradley-Burns Uniform Local Sales and Use Tax Law (Rev. & Tax. Code, § 7200 et seq.) in effect on January 1 of that year; and

(C) The weighted average rate of the district taxes imposed under the Transactions and Use Tax Law (Rev. & Tax Code, § 7251 et seq.) in effect in the various jurisdictions throughout the state on January 1 of that year after taking into account the proportion of the total statewide taxable transactions (by dollar) reported for each jurisdiction during the fourth quarter of the calendar year that is two years prior to the calendar year for which the calculation is made. For example, the total reported taxable transactions (by dollar) for the fourth quarter of 2010 shall be used to determine the weighted average rate of the district tax rates in effect on January 1, 2012, to calculate the weighted average rate of district taxes for calendar year 2012.

(c) CALCULATION OF THE ESTIMATED USE TAX LIABILITY.

(1) The estimated use tax liability for the AGI range described in subdivision (b)(1)(A) shall be determined by multiplying \$10,000 by the use tax liability factor or use tax table percentage and then rounding the result to the nearest whole dollar.

(2) The estimated use tax liability for the AGI ranges described in subdivision (b)(1)(B) through (G) shall be determined by multiplying the midpoint of each AGI range by the use tax liability factor or use tax table percentage and then rounding the result to the nearest whole dollar.

(3) The estimated use tax liability for the AGI range described in subdivision (b)(1)(H) shall be determined by multiplying each range member's actual AGI by the use tax liability factor or use tax table percentage and then rounding the result to the nearest whole dollar.

(d) USE TAX TABLE FORMAT.

(1) The use tax table for calendar year 2011 shall provide as follows:

| Adjusted Gross Income (AGI) Range | Use Tax Liability |
|---|--------------------------|
| Less Than \$20,000 | \$7 |
| \$20,000 to \$39,999 | \$21 |
| \$40,000 to \$59,999 | \$35 |
| \$60,000 to \$79,999 | \$49 |
| \$80,000 to \$99,999 | \$63 |
| \$100,000 to \$149,999 | \$88 |
| \$150,000 to \$199,999 | \$123 |
| More than \$199,999 -Multiply AGI by 0.070% (.0007) | |

(2) The use tax tables for calendar year 2012 and subsequent years shall utilize the same format as the use tax table for calendar year 2011.